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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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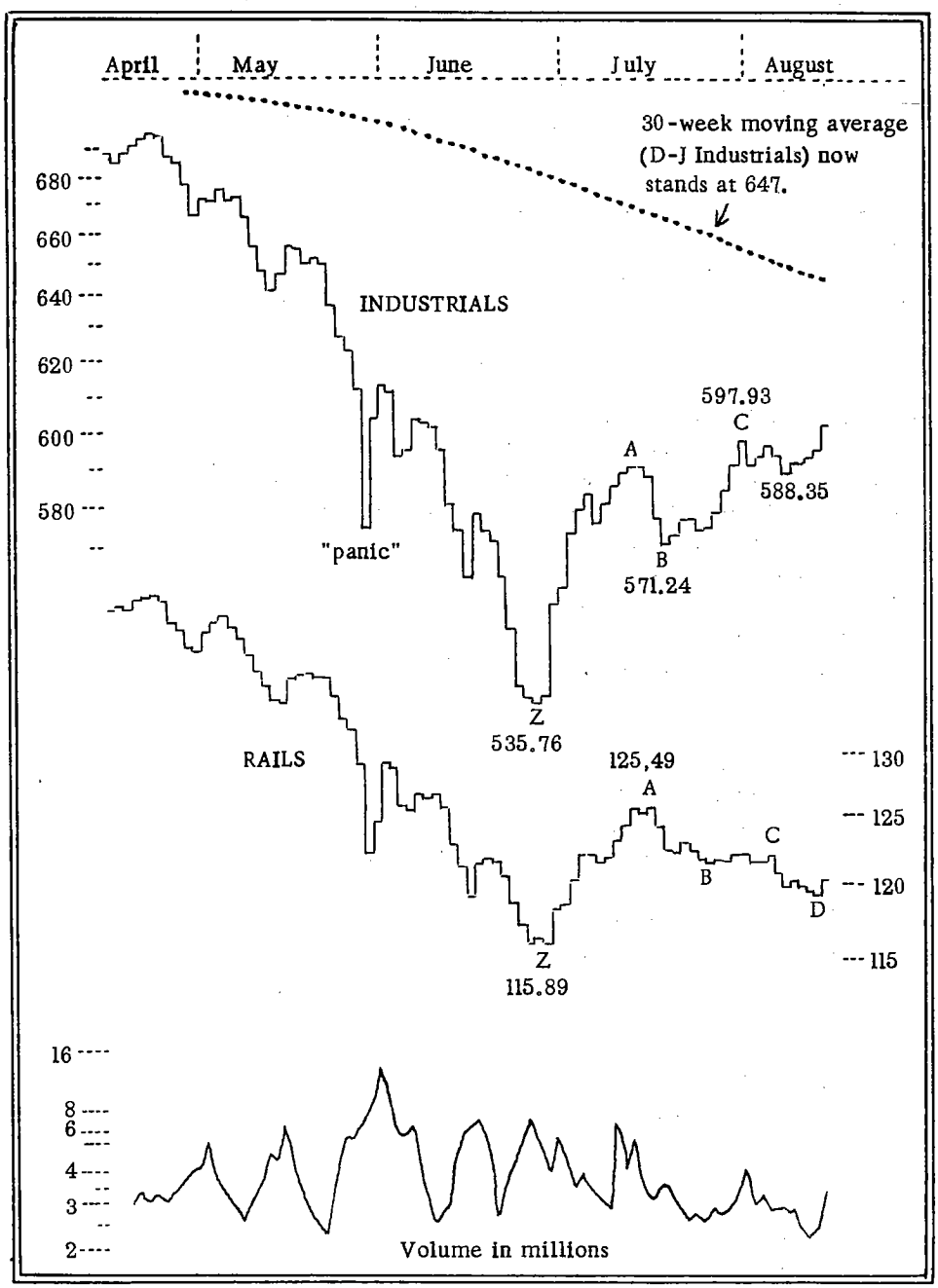
THE MARKET Letter 189 drew attention to the series of narrow fluctuations in the Rail Average, and it was stated that the carrier index appeared to be in a "line" formation. At the same time I hazarded a guess that Industrials too might be in the process of forming a line. Over the past two weeks the action of Industrials has been confined to a ten point range bordered by 597.93 on the top and 588.35 on the bottom (see chart). This would indeed provide the appearance of a line in the senior Average.

To make matters a bit more confusing, on August 6 Rails broke sharply below their lower line limit. This penetration was immediately followed by a series of lower Rail closings, and by early this week the carriers had succeeded in giving back better than 60% of all recovery gains since the June 24 lows. Against the current pronounced downward zig-zag in Rails (A-B-C-D), the Industrial Average has held persistently in its line area; the upward zig-zag in Industrials (Z-A-B-C) thereby remains in force.



Thus we have a picture of marked divergence between the two Averages. When persistent divergence occurs (to use the old expression), "something's got to give." One of the two Averages is now telling the true story. If Industrials rise to new recovery highs followed by an "in gear" advance in Rails, the situation could yet resolve itself into one of gathering strength (assuming that Rails eventually confirm by bettering their preceding peak of 125.49 at point A).

Conversely, if Industrials turn down (even though they rise to a recovery high first) and break their lower line limit (D - 588.35) on increasing volume, the picture will appear ominous. If such a move resulted in a penetration of the preceding Industrial low at B (571.24), this writer would put the odds at better than 50-50 that the third primary bear leg was underway.

TRADING In his famous book "How to Trade in Stocks" (long out of print), Jesse Livermore wrote: "I know but one sure tip from a broker. It is your margin call. When it reaches you, close your account. You are on the wrong side of the market. Why send good money after bad? Keep that good money for another day. Risk it on something more attractive than an obviously losing deal."

My life would be easier if all trading-subscribers fully understood the implications of Livermore's words. The above thought was amplified in another part of Livermore's book: "If you have timed the movement correctly, your first commitment will show you a profit from the start. From then on, all that is required of you is to be alert, watching for the appearance of danger signals to tell you to step aside and convert paper profits to real money."

I could not agree more. I do not think I ever made money on a position which immediately produced paper losses. I do not know that I ever regretted selling stocks purchased in an area that I believed to be a "buy-spot" when that buy spot was followed by weakening prices and paper losses.

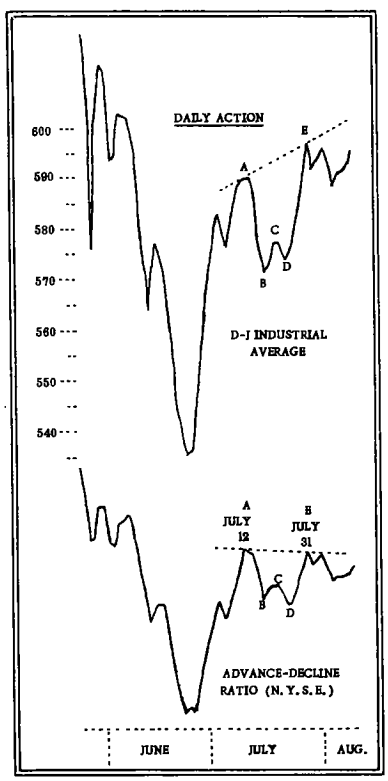
All the above applies to trading in both bull and bear markets. The single exception is when one accumulates great values at what appears to be a major bear market bottom. In 1949 volume was dull (running under one million shares for months on end), yields were generally around 6-10% on "blue chip" stocks, and the technical position of the market was strong. The investor who bought good stocks in 1949 was being paid handsomely (in dividends) while he waited. Conditions are far different today. Yields are unattractive, the technical position of the market is questionable, nothing resembling a major bear market bottom has yet appeared. For this reason, those who buy stocks must heed Livermore's words. If you buy a stock here and later receive either a real margin call or a theoretical margin call (via paper losses), get out. The market is giving you its finest "tip" -- you're wrong.

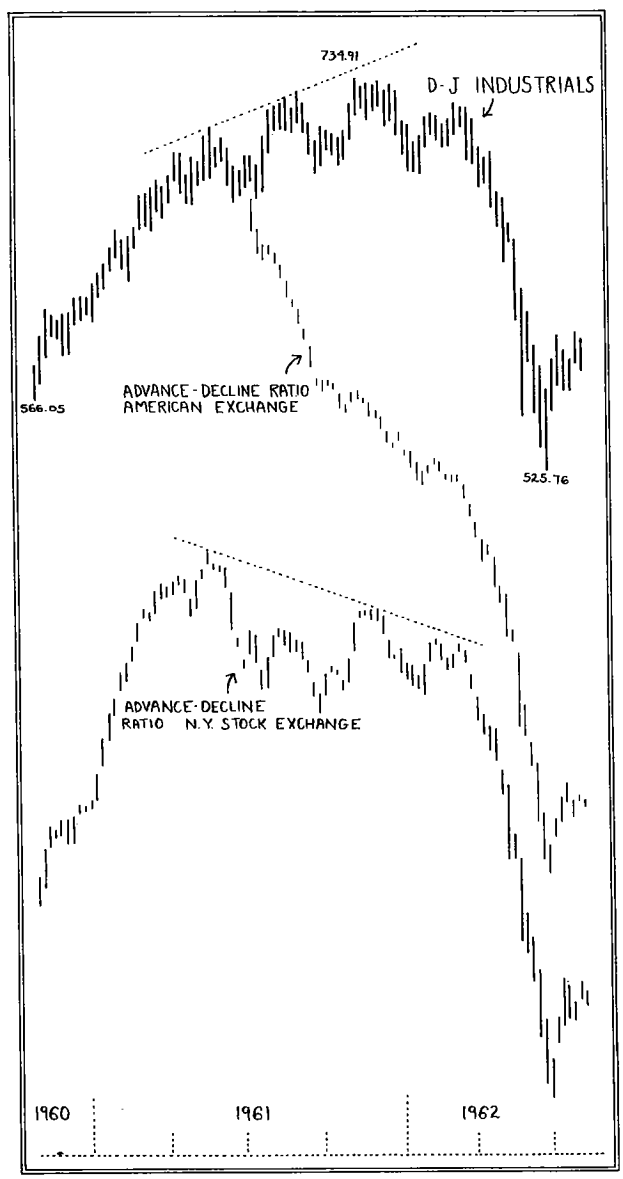
THE "MARKET" AND THE AVERAGES Following up the discussion of the advance-decline ratio (1929 and 1937) which appeared in last week's Letter, it might be worthwhile to go into the current status of the A-D ratios on both the American and N.Y. Stock Exchanges.

The larger chart shows the weekly high and low range of the A-D ratios on the two Exchanges plus the weekly high-low range of the Industrial Average. This chart dramatizes the 1962 collapse in terms of price (Industrial Average) and "breadth" (advance-decline ratios).

Note the severe cave-in of the A-D ratio on the American Exchange, and the relatively sluggish recovery of that ratio since the June lows. This would suggest that the mass of speculative stocks (the American Exchange tends to represent the more speculative list) has shown little rallying power. What money has come into the market since the June lows has been confined to a large degree to the "blue chip" issues.

Also of interest (although it cannot be illustrated here) is the fact that the Industrial Average at its June 24, 1962 low, had fallen back to its September, 1958 level. But the A-D ratio at its June 24 low had broken to the levels of January, 1954! This action is all the more shocking when one realizes that in September, 1958, the Industrial Average stood at 525 while in January, 1954, the Industrial Average was 280. The implication is that the general market has sustained a much greater degree of damage than almost anyone realizes. Moreover, if the Industrial Average were now to sink to the comparable current level of the A-D ratio, we could expect a price of approximately 280-320 for the senior average. In view of this, Mr. Donald McKee of Paine, Webber in San Diego was kind enough to put in some research hours for me. He compiled a list of 183 leading and representative N.Y. Stock Exchange issues. He then recorded the price range of each issue from the period of 1949 to the present, and he divided the price range of each stock into four quarters or equal zones. The final





statistics are little short of amazing. It showed 44 (24%) of the stocks in zone 1 or the bottom 25% of their 1949-62 range, 73 stocks (40%) in zone 2 or below the halfway level of their 1949-62 range, 62 stocks (34%) in zone 3, and only 2 stocks (2%) in the top 25% of their 1949-62 range. This means that a total of 117 (64%) out of 183 stocks are below the 50% level of a thirteen year bull market range. CONCLUSION: anybody who claims that we have not been in a bear market simply has not acquainted himself with the figures.

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The second chart shows the current daily action of Industrials and the A-D ratio, and this picture is now deserving of particular attention. On July 12 (A on chart) Industrials and the A-D ratio registered recovery highs for the move which began on June 24. A decline to B ensued, followed by a minor rally to C and then a second decline. On the second decline to D, the A-D ratio broke below B, but this penetration was not confirmed by Industrials. At that point, however, we had our first important indication that the general market (A-D ratio) was lagging behind Industrials.

The latest advance to new Industrial recovery highs at E was not confirmed by the A-D ratio, and again the market turned down. This situation now allows for a possible bearish series of two non-confirmations between Industrials and the A-D ratio. The majority of major declines since 1919 have stemmed from (1) joint peaks on the Industrials and A-D ratio; (2) a second higher peak on Industrials unconfirmed by the A-D ratio; (3) a third and final higher peak on Industrials still unconfirmed by the A-D ratio.

Conclusion: If Industrials rise to a new recovery high above 597.93 (unconfirmed by the A-D ratio) and then turn down -- we will have received a major "sell-signal."

MISTAKE OR BEAR MARKET? A great deal has been written to the effect that the 1962 drop was just a "shakeout" brought on first by the news of the "Kennedy-steel" altercation and second by the sudden realization that this Administration was not going to help business. In an effort to dismiss the bear market, one well-known investment advisor recently stated that "everyone knows the reason for the present break. But true bear markets come unexpectedly, no one knows why."

I do not go along with that line of reasoning. Throughout 1961 I drew attention (in both these Letters and in Barron's) to the fact that the two Averages were refusing to "get in gear". From the period of May, 1961 to the end of that year the Averages were unable either to rise jointly to new highs or to break jointly to new lows. When such persistent divergence occurs, it is a safe bet that distribution is taking place. The following quotes are from the pen of Robert Rhea. These passages refer to the final stages of three bull markets and the implications of divergence at those tops.

"A wise man lets the market alone when the Averages disagree. An operator following that policy in 1901 and 1902 would have saved commissions and probably some losses by simply refraining from trading as long as the Averages were 'out of gear' ". (1902 bull market top).

"Any student of Dow's Theory who did not unload stocks reasonably near the top needed a guardian. High volume, inability of the Averages to progress under forced pressure, divergence, were all danger signals easily recognized." (1906 bull market top).

"From the latter part of July to the end of the year 1909, the Averages performed in a most confusing manner. The Rails established a series of successively lower peaks and valleys, while on several of these movements the Industrials acted contrawise.

When the averages disagree, they are shouting 'be careful'. Except for uniformly high volume, nothing indicated the forthcoming collapse; however, it could be seen that a great deal of fuel was being burned in the stock market boiler without generating enough steam to carry the price structure forward." (bull market top of 1909).

CONCLUSION: The 1962 collapse was no "mistake"-- it was not brought on by news alone. The break had been preceded by a long period of distribution. From everything we know of previous market action, the extended series of divergent movements in the Averages during 1961 suggested that important distribution was taking place.

LATE NOTES (Written Wednesday, August 14, 11 A.M., N.Y. Time). Yesterday saw Industrials rise 6.61 points and Rails 1.01. This action put Industrials at a new recovery high of 601.90; it also placed the market in position for an important "test."

Referring to the "daily action" chart on page 2 of this Letter, Industrials have now risen above point E. Yet yesterday's rise failed to take the advance-decline ratio above either point E or A. If another day or so of rallying action succeeds in taking the A-D ratio above point E and then above A, the market will be in position to extend its advance (perhaps dramatically so). A plurality of 373 more advances than declines is all that is needed to bring the A-D ratio above its July 12 peak and thereby confirm the new recovery high in Industrials.

Conversely, if the market now stalls in this area (with advances not able to substantially exceed declines), and then turns down, we will have a major "sell signal." The import of such a sell signal would be underscored by the lagging performance of the Rail Average. The Rails are still four points below their July peak at A (125.49). A reversal here would be completed by an Industrial penetration of its lower line limit of 588.35 -- on increasing volume.

This morning (Wednesday, August 14) both Averages opened up strongly with Industrials higher by four points and Rails up almost a point. Unless the market sells off later in the day, it would seem that the A-D ratio is headed for a new recovery high.

STOCKS I have illustrated (below) a few of the difficulties in the difficult "art" of stock charting. Burroughs, recommended earlier, has formed an upward slanting "wedge". A wedge differs from a triangle in that both trendlines slant up (or down). When the wedge points up and volume peters out, it usually means that the stock has run out of steam. As seen below, Burroughs has broken below the lower trendline. This writer therefore sold his BGH and sustained a small loss.

Chrysler, discussed in the last Letter, showed unimpressive volume on the breakout from the reverse "head-and shoulders" pattern. The stock then pulled back to the "neckline" (dotted line on chart). But this week volume came into Chrysler and the stock moved up to a new recovery high. Therefore, those who bought Chrysler on the breakout received a bit of a scare, but things turned out all right a few days later. The stock is now heading into stiff resistance in the 56 area. That area (arrow) is just below the February-March top, from which the stock broke to its 1962 low.

A third interesting problem is Standard of California. The stock has formed a bullish ascending triangle, but the price movement has wandered out towards the end of the triangle. When this happens, the strength of the pattern is usually diluted. Here we see a stock which resisted beautifully on the entire 1962 collapse. But instead of leading on the recovery, SD has lagged with small profit to the buyer (so far).

Stocks that look strong -- Florida Power & Light, Crown Cork, Bristol Myers, Fairchild Camera, Beckman, Varian. Strangely, many of last year's "glamour stocks" (which sustained the biggest losses) now look strongest from a chart standpoint.

Charts courtesy of Traders Research, Inc., P.O. Box 2644, St. Louis 16, Mo.